Citi Wealth

Asia Pacific *Regional Publication*

Jaideep Tiwari
Head, Global Foreign Exchange Investment Strategy

February 6, 2024

FX Focus: USDJPY - Bank of Japan may be on the path towards multiple hikes

FIGURE 1: USDJPY Forecasts

Forecast (Jan 2025)	Spot	0-3m	6-12m	Long-term
USDJPY	**156.00**	**155.00**	**143.00**	**130.00**

Source: Citi Wealth Investments as of January 2025.

The Bank of Japan (BoJ) hiked its policy rate from 0.25% to 0.50% at its January meeting, indicating "the likelihood of realizing the (BoJ's) outlook has been rising" and pointing to gains in wages in spring wage negotiations. The BoJ also judged "global financial and capital markets have been stable on the whole" despite uncertainty around US trade policies, suggesting the current environment allowed the BoJ to hike rates.

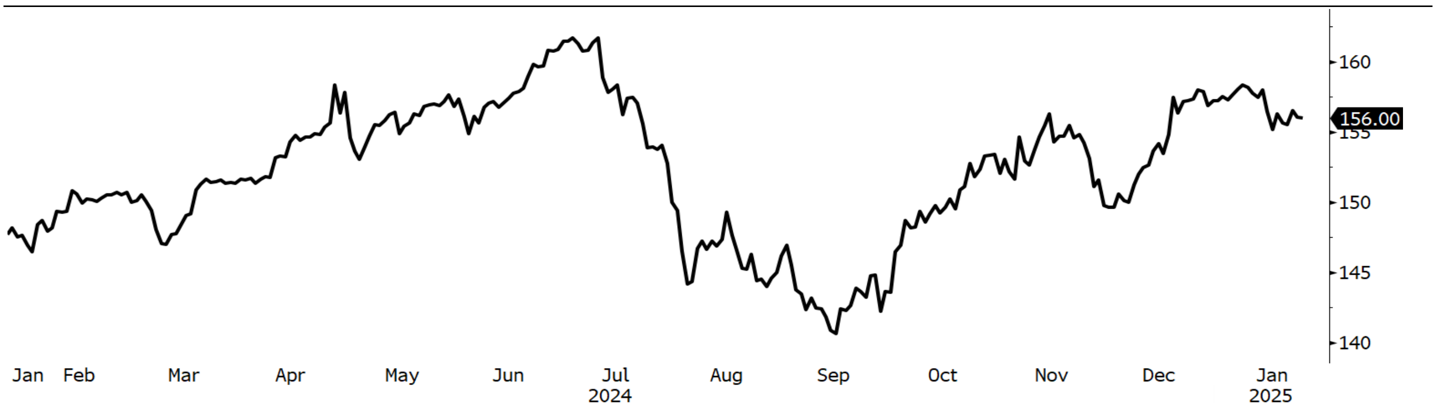
The BoJ also raised its Japan's core inflation forecast to 2.7% for FY2024 (+0.2ppt from October), 2.4% for FY2025 (+0.5ppt) , and 2.0 for FY2026% (+0.1ppt) . There were upward revisions to core-core CPI forecasts as well and BoJ's Outlook Report stated that Japan's labor market seems to be tightening more than the estimated output gap suggests. This was hawkish.

However, markets focused on Governor Ueda's attempts to water down the hawkish BoJ statement as he pointed to the inflation forecasts being largely due to cost-push factors, and that the rise in the subjective measure of underlying inflation tracked by the BoJ remained moderate. This led to a rather mixed price action in the Yen post meeting and with the price action inconclusive, the immediate focus now is likely to be on the extent of wage hikes in the upcoming spring wage negotiations and possible income tax cuts during upcoming budget discussions in the Diet. If there are positive surprises here, this could bring BoJ's rate hikes forward.

The BoJ also pointed to "higher import prices stemming from the recent depreciation of the Yen" causing inflation pressures to rise. This means a weaker Yen could make BoJ more responsive to Yen weakness. Meanwhile comments from President Trump suggest an extended toned-down posture in addressing the US trade deficit. On Japan more specifically, Citi Economics expect the effective US tariff rate on Japanese goods to gradually increase by 5ppts (from the current c2% to c7%) this year. This is unlikely to pose a headwind for JPY.

Yen rates now discount a BoJ policy rate of 0.75% by year-end and even if the BoJ overnight rate just hits 0.75 – 1.0% and Fed cuts rates twice (50bp) as expected, the current yield gap of +375bp between the Fed Funds rate and BoJ's overnight rate could drop to below +300bp by year-end, a level where Yen – carry trades could become potentially unattractive. Narrowing short rate differentials are also likely to flow through to longer dated yield spreads and a sub +250bp 10Yr UST – JGB yield spread could make US Treasuries expensive relative to Japanese government bonds, potentially triggering Japanese funds to sell their US bond holdings and repatriate from some of the estimated USD1.8trn in foreign assets FX unhedged that they hold. This in turn may cause USDJPY and EURJPY to drop more sustainably than has been the case over the past year.

FIGURE 1: USDJPY has risen since Sept – end pricing the Trump trade but now appears to plateau



Source: Bloomberg, January 27, 2025.

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